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I.

Introduction

Observers of developments in the financial services industry have been perhaps unduly impressed by the acquisitions or mergers of well-known securities firms which have been announced in the past few months, as well as the likelihood that more will take place. Thus the Morgan Stanley Group merger with Dean Witter is seen as striking in itself while it is forgotten just how recently Dean Witter was spun off by Sears Roebuck which had, in turn, acquired Dean Witter in the nineteen-eighties,[1] a time when there had been other similar acquisitions, some digestible (Donaldson, Lufkin & Jenrette, Inc. by Equitable Life Assurance), some

[1]It should also be remembered that as recently as December, 1996 Dean Witter had acquired Lombard Institutional Brokerage, Inc., a broker which had built an Internet discount business.

partly digested (Bache, Inc. by The Prudential Insurance Company of America)[2] some like Dean Witter and Lehman Brothers, Incorporated (acquired by American Express Company), undigested and spun off, Dillon Read (also a current rumored acquisition candidate) several times bought and undigested sold back to its employees and, in the same vein, General Electric Company's acquisition of Kidder Peabody. Also along these lines the acquisition of the two hundred year old Baltimore based "regional" investment banker Alex Brown, Inc. by New York headquartered Bankers Trust Company or the rumored acquisition of Oppenheimer & Co. Inc. a mid-size New York securities firm by PNC Bank Corp. of Pittsburgh, both in the name of synergy - the brokers' equity based initial public offering prowess combined with the fixed income strength and Fortune 100 client base of the bankers - are consolidations familiar from earlier such transactions.

What is also forgotten is that the process of consolidation within the securities industry[3] has continued virtually unabated from the late nineteen sixties, driven then by the need to find capital to modernize back-office procedures to meet the "paperwork crunch" (which had in 1968 and 1969 kept the primary market, the

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[2]Bache in its time had acquired Halsey, Stuart and Shields & Co., among other firms.

[3]In recent years there has also been considerable consolidation within the banking business; witness the growth of NationsBank and others.

New York Stock Exchange, closed on Wednesdays), into the mid and late seventies. In a time of little market volume the Exchange pressed merger on its venerable but weaker members so that, among other consolidations,[4] Dean Witter acquired Reynolds & Co., Smith Barney acquired Harris Upham, Lehman Brothers acquired Kuhn Loeb, Burnham & Company acquired Drexel Firestone (and thereby a young trader named Michael Milken), Merrill Lynch - whose culture had changed over the years from retail to investment bank and then back - acquired investment banks White Weld and A. G. Becker (which had only shortly before been acquired by a French bank) and the then Shearson (acquired in 1994 by Smith Barney, which had been acquired by The Travelers Inc.) acquired literally dozens of firms.

Even those well-known firms which remained independent, Goldman Sachs, Salomon Brothers and Morgan Stanley added to their capital to meet the growth of capital intensive fixed income markets in the nineteen eighties by selling substantial minority stakes to other entities or to the public.[5] That the process of purchase or investment by foreign and domestic banks, insurance companies and other entities

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[4]The number of NYSE firms fell 14% between 1968 and 1970. An even greater reduction among brokerage firms took place between 1987 - 1990 when 20% of firms closed. SIA Trends Vol. XXIII, No. 1, January 31, 1997, p. 3 and 18.

[5]It should be noted that Morgan Stanley's capital in 1970 was $7.5 million, Chernow, The House of Morgan, New York, 1990, p. 586. Morgan Stanley Group Inc.'s capital at January 1, 1996 was above $15 billion; 2,000 times larger.

has continued over considerable time can be seen by the listing of Securities Industry Association member firms owned entirely (Appendix A) or partially (Appendix B) by others.[6]

It should also be recognized that banks did not stay aloof from the massive growth of the securities industry in the past decade but have steadily increased their securities related activities through Section 20 broker-dealer subsidiaries and otherwise. And lastly, since regulatory efficiency is a theme of this hearing, it should be remembered that the major firm which created the greatest concern in recent years was the home-grown, almost entirely securities oriented dealer, Drexel Burnham Lambert, although the Lambert name indicates that it also had a substantial minority ownership by a foreign bank.

The Drexel matter should remind us that not only may holding companies be placed at risk by the activities of their subsidiaries but that subsidiaries may put

[6]At this point I must state two disclaimers. One, over the past year my firm or I have provided legal services to a number of firms mentioned above as recent or rumored acquisitions; among these are Bankers Trust Company, Dean Witter, Morgan Stanley and Oppenheimer. Two, my comments are based on my career which has almost entirely dealt with broker-dealers and investment advisers. Thus, while I have been retained by banks and insurance companies it has always been with regard to their securities activities. I have, accordingly some knowledge of insurance and banking regulations, but hardly expertise. As a result, my perspective is that of a securities law practitioner.

their public customers and counter- parties at risk through the activities of their parents.[7] Further, in this regard, we should recognize that in considering regulation, while some entities may be legally owned by parent corporations, in fact, the entities' control may be at the holding company level. Additionally, we should understand that financial service companies are no longer just isolated as banks or brokerages and the like but may now or in the future share finances, management and ethics as part of a business enterprise with real estate development and even manufacturing activities. And we should be aware that financial service companies are protean, changing shape and service as times demand. Ten years ago who would have expected the high profitability and market share of discount brokers, the flexibility created for securities registered professionals by franchise brokers and the growth of hedge funds; much of these made possible by the increased capital, excellent technology and lower transaction costs of clearing brokers.

I would suggest though that the current prominence of acquisitions does focus attention as to how regulation should be effected across the enterprise, the owned entity, internationally, nationally and by states, and in consideration of the specific business involved in entity and enterprise. In putting the question: what

[7]A result of Drexel Burnham Lambert's failure in 1990 was the SEC's adoption of Rules 17h-1T and 17h-2T which provide information regarding parents and other persons associated with broker-dealers so as to assess risks by such entities to the broker-dealer.

level of regulation is appropriate for holding companies (understanding that banks, for example, are regulated at that level) - or as I would ask it - what are the reasonable expectations of fair dealing and fiscal responsibility of contra- parties and customers who deal with and use the services of banks, brokerages, insurance companies, and investment advisers in a diversified financial services complex - we are both accepting that regulation, in itself, is both a necessity and a benefit, and that the crux of analysis relates to enterprise vs. entity. Thus wherever a diversified financial company exists the regulatory choice should not be seen as between an umbrella regulator and functional regulation, subsidiary by subsidiary, but rather in understanding that we have moved beyond viewing the regulated entity in isolation, to placing it in the context of its parent and affiliates. In that context, control is the linchpin of enterprise liability and responsibility.[8]

II.

What We Start With

A great deal of law, lore and skilled commentary, not to neglect money, has helped develop the present expertise of regulators. Thus to speak only of the SEC,

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[8]See, for example, New York Stock Exchange member applications dealing with affiliates of member-firms (referred to as associated members) , and Exchange Rule 354 requiring an annual compliance report of the member-firm to be provided to its parent. See also New York State requirements that insurance companies report about their subsidiaries to the Superintendent of Insurance.

the agency with which I am most familiar, not only has it attracted over the sixty-three years of its existence a highly able staff, but its sophistication as to how capital markets operate is nearly that of securities professionals. The Commission has in the past decade shown a deft hand in regulating markets so that capital is apportioned to its most productive use. Examples of this sophistication are readily seen in the recent releases adopting Regulation M which addresses manipulative concerns in underwritings and the Order Execution Rules which seek to improve price transparency and better executions for investors.[9] Even where there is a problem of extraordinary complexity such as preferencing of customer order flow the Commission's expertise allows it to frame properly the issues of debate and analysis, even if an agreed solution is not yet forseeable.

On the other hand, it may be expected that the SEC's knowledge of banking or insurance regulation is limited in the same way as its counterpart regulators in those areas are as to securities. In those instances in which I have come across bank regulators, for example, seeking to examine the securities operations of bank holding companies I have been struck by the regulators lack of feel for the texture of the securities business. Insisting on audit trail procedures above all else is not

[9]SEC Release No. 33-7375, January 3, 1997 (Regulation M); SEC Release No. 34-37619A, September 6, 1996 (Order Execution Rules)..

just a matter of trees and forest but a fundamental misunderstanding of where problems lie in securities firms. These are real-time rather than hindsight matters, often ethically driven, that is, sales practice violations, self-serving research, "wooden" trading tickets and the like. I assume that an SEC examiner of banks or insurance companies would similarly get it wrong.

It is also important to realize that regulation of each of the major financial areas has not yet been rationalized.[10] Thus three federal as well as state regulators police the banking business, the states regulate insurance and the securities industry is a jerry-built collection of federal, state and self-regulation.

Further to the regulation of these businesses we must understand several individual items which affect their profile: first, although the risks assumed through proprietary trading and otherwise of securities firms are higher than those of banks, historically banks' return on equity has been higher than that of securities firms;[11] second, the role of bank regulators has been to promote the safety and soundness of

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[10]With the adoption of National Securities Markets Improvement Act of 1996 the investment advisory business is an exception.

[11]For risk profile see: The Economist, March 2, 1996, p. 67; the Wall Street Journal, March 8, 1996 and May 6, 1996; for return comparison see SIA Trends Vol. XXII, No. 5, November 22, 1996, p. 2.

banks, that of securities regulators is consumerist in direction; third, the banks have suffered from disintermediation over the past decade and now have about half the money on deposit they once had, but traditional brokers are subject to the same process of loss of commissions and control of assets through customer use of the Internet to enter transactions; lastly, acquisition is not purely a domestic phenomenon, major international banks such as Swiss Bank Corporation and Deutsche Bank, through acquisitions of merchant and investment banks, have invested heavily in building corporate finance capacity.

These factors teach that in considering enterprise regulation we must build on the strengths and recognize the weaknesses we now have. So as not to lessen competition we must also understand each financial service business as it is by itself and in relation to others. In the case of the securities industry since the deregulation of fixed commissions in May, 1975 firms have developed profitable niches at every point in the capital market environment, exactly as would have been predicted by an economist Darwin. And those niches are contested, competitive.[12]

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[12]"Today, firms are bigger, much better capitalized and far better able to compete not only among themselves but with other financial institutions such as commercial banks." SIA Trends, Vol. XXIII, No.1, January 31, 1997, p. 8. See also f.n. 5 supra.

Thus four firms have 95% of the discount brokerage market, a niche, representing 15% of all commission business, which did not exist twenty years ago.[13] Lombard Institutional Brokerage, Inc. (referred to in footnote 1 above) in the four years from its inception created an internet based discount firm of sufficient interest to a full-service brokerage to be purchased for $70 million. Firms which trade electronically through the NASD's Small Order Entry System established in 1988 claim to represent 20% of all over-the-counter trading[14] while Instinet an electronic exchange operating in the guise of a broker since 1989 may represent as much as 50% of Nasdaq trading.

The barriers to entry into the lower reaches of the securities business are largely regulatory. Thus state licensing creates unnecessary costs;[15] for innovators the SEC's no-action procedure may create major delays and legal fees (Instinet took two years to obtain a no-action letter to operate as a broker-dealer); the NASD's pre-membership interview process runs as much as six months, easily five months

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[13]SIA Trends, Vol. XXIII, No. 2, February 28, 1997, p.7.

[14]See: Position Paper of the Electronic Traders Association: HTTP://W.W.W.Electronic-Traders.ORG.

[15]On April 28, 1997, pursuant to direction of the National Securities Markets Improvement Act of 1996, SEC staff met with blue sky commissioners. The SEC is to report to Congress by October 11,1997 regarding attaining uniform licensing requirements as to associated persons of registered broker-dealers.

too long, and testing requirements for individual registration do not take into account the individual's education, experience or even whether he will be dealing with the public.[16] Yet the examples given above indicate that such barriers have been overcome by innovators.

At the higher elevations the barriers are imposed through bank regulations and the economic concern of cost versus return. Thus an entity such as Bankers Trust Company, referred to above, rather than lose the time in building its own equity origination capacity and market share may seek to obtain these through acquisition. In such situations it is common to see as a barrier in what is perceived as different business cultures; the retail customer driven Dean Witter as compared to investment banker/trader Morgan Stanley; the regional investment banker Alex Brown and the world-wide commercial bank and fixed income originator and trader, Bankers Trust. As noted in the Introduction, not all acquisitions take but clearly the recently announced deals fit into rational business plans designed to present to customers a broad range of financial products, advice and expertise on a global scale.

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[16] In a recent, almost surreal experience, I was retained to form a broker-dealer by two attorneys who had recently left positions in the SEC's Enforcement Division. Each now has to take licensing examinations.

Therefore assuming that consolidations of various types will continue across and within a number of diversified financial services providers what regulatory structure will best address these enterprises?

III.

A Regulatory Structure For Enterprises

While historically legal theory viewed a corporation as a separate legal entity with its own rights and duties there has been growing acceptance of the concept of enterprise wide liability in tort and contract law, legislative action and the administrative implementation of regulation.[17] This concept is reflected in the Foreign Corrupt Practices Act as well as Section 15 of the Securities Act of 1933 and Section 20 of the Securities Exchange Act of 1934 which provide for potential liability of persons in control relationships with primary violators of these Acts. A simple review of the registration forms of broker-dealer and investment advisor subsidiaries of holding companies will note that the parent corporation and above are scheduled as control persons.

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[17]The leading analysis of this is found in Phillip I. Blumberg, The Increasing Recognition of Enterprise Principles in Determining Parent and Subsidiary Corporation Liabilities, 28 Conn. L. Rev. 295 (1996).

Ultimately in determining responsibility legal theory follows function. There is nothing strange about this. A typical enterprise structure reflects the actuality that the subsidiaries are businesses, not mere legal entities, and as businesses they report to and are watched or even directed by their owners. Thus the enterprise will have typically, among other measures of control, one or more of its executives serving on subsidiary boards, an internal audit department integrated with or reviewing the work of similar departments at the subsidiary level and dotted line reporting by subsidiary general counsel to the ultimate parent's legal department. Assuming subsidiaries are properly capitalized then the residue of liability at the holding company level would relate only to systemic failings in its owned entities. It is only these which pose a risk to markets, contra-parties and the enterprise itself.

Essentially then legal theory is in place to regulate complex, large even global corporate enterprises. What must be addressed and enacted is the most useful regulatory structure to accommodate the nature of these businesses.

In this regard, I believe the necessary first step must be to rationalize the present system of regulation. In the securities industry this means 1) pre-empting the states' licensing requirements, while maintaining their ability to respond to fraud;[18] 2) understanding that the exchanges are competing markets and that their self-regulatory role should be limited to policing those markets; and 3) re-thinking the separation from the norm of securities regulation of municipal securities and those financial futures used to hedge securities transactions.

The second step is to analyze the particular enterprise to determine what is its dominant, or predominant, business mode. Once understood, those regulatory agencies with experience and expertise in the given businesses would play their proper role. Thus there would be no new regulatory bureaucracy but rather effective liaison based on existing supervisory structures.

To move from the theoretical to the actual I would envision a structure to regulate diversified financial enterprises which have one or more regulated units as follows:

1. Enterprises whose capital or revenues related to financial services are below a certain level would continue to be regulated as they are now;

[18]Even as to fraud, too many jurisdictional cooks can spoil the broth. Thus in New York I am aware of separate securities fraud investigations being conducted not just by the SEC, but by the U. S. Attorneys for the Southern and Eastern districts, the New York State Attorney General and even the Manhattan District Attorneys Office.

they represent minimal danger to markets and others with which they do business.

2. Enterprises whose capital or revenues related to financial services are above a certain level would be divided between those which:

   A. Have 80% (or another high percent) of such capital or revenues in one particular financial business ("Dominant Business Enterprise"); or

   B. without a dominant financial business, have one such business larger than the others ("Predominant Business Enterprise.").

3. A Dominant Business Enterprise, if a bank, for example, would be regulated at the enterprise and dominant unit level by a bank regulator; its other units would be regulated by an appropriate industry regulator which would report on a liaison basis to the bank regulator only as to systemic risks created by the entity.

4. If in a Predominant Businesss Enterprise, the largest unit was, for example, a bank, its regulator would act as Chairman of a Board composed of each relevant regulator; the Board's function would be to set standards for the enterprise's control of its various units and to monitor the enterprise's activities through reports of the various regulators; the Board would have neither a policy making nor enforcement role, these would remain with the individual regulator of each regulated entity.

I would note also that the above formulation would respond to the Group of Seven's 1996 proposal of that each member country designate a single, lead regulator for diversified multinational financial institutions which operate in that country.[19]

IV.

Summary

The current wave of announced and rumored acquisitions of securities firms continues a three decade old process. Driven by business needs to service a larger

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[19]See: "G-7 Leaders Mull Proposal to Assign Lead Financial Regulator", 28 Securities Regulation & Law Report 831, July 5, 1996.

and more diverse client base globally we can expect more such acquisitions and an even increased number if the securities markets weaken and brokerages revert to their historic lower levels of profitability. Given relatively modest barriers to entry into the securities industry we may expect both innovation and competition to service customers at every level.

The focus on intra-industry and cross industry acquisitions at a time when it is apparent that among world capital markets American markets are the strongest but others are reasonable competitors requires the review of regulation of diversified financial companies on an enterprise basis and in relation to their international activities. In that regard the considerable experience of regulators in securities, banking and insurance should be built upon, while redundancy among regulators is eliminated.

The trend of legal and regulatory theory is to hold enterprises responsible for the activities of their owned entities, when these entities have had systemic failings or created risks to the enterprise, markets or contra-parties. The keystone of such responsibility is the control wielded by the enterprise at its senior levels in holding subsidiaries to effective business plans.

A sensible approach to enterprise regulation would a) address only the largest such companies; b) allow the relevant present regulator to be responsible for enterprises which are dominantly in one industry, while receiving information from those regulators which continue to regulate the enterprise's other activities as to concerns affecting the enterprise as a whole; and c) as to broadly diversified enterprises, create a standard setting board of regulators to monitor the enterprise's activities while leaving regulation of specific entities to the relevant industry regulator.